

OCT 15 1993

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of)

Accounting for Judgments and)
Other Costs Associated with)
Litigation)

CC Docket No. 93-240 *P*

TO THE COMMISSION

REPLY COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY

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Table of Contents

<u>Subject</u>	<u>Page</u>
Summary	i
I. INTRODUCTION	2
II. THE PROPOSED RULES SHOULD NOT BE ADOPTED BECAUSE THEY CONFLICT WITH ESTABLISHED JUDICIAL AND REGULATORY STANDARDS.	5
III. THE PRESUMPTIONS PROPOSED IN THE NPRM ARE FUNDAMENTALLY UNFAIR.	8
A. The NPRM Uses an Unfair, Arbitrary and Capricious Standard as a Basis for its Presumptions.	8
B. The Rationale for Imposing the Presumption is Based on False Assumptions.	12
IV. IMPOSING A PRESUMPTION OF DISALLOWANCE ON SETTLEMENTS MERELY BECAUSE THERE ARE ALLEGED VIOLATIONS OF ANTITRUST OR FEDERAL STATUTES IS ARBITRARY AND CAPRICIOUS, AND WILL HAVE AN ADVERSE AFFECT ON LITIGATION.	14
A. The Presumption of Disallowance is Arbitrary and Capricious.	14
B. The Presumption of Disallowance of Settlements Should be Rejected Because of the Adverse Effect on Litigation.	15
V. THE PROPOSAL THAT CARRIERS BE REQUIRED TO TRACK LITIGATION EXPENSES IN A BALANCE SHEET DEFERRAL ACCOUNT IS CONTRARY TO GAAP, OVERLY BURDENSOME AND WILL CREATE ADVERSE LITIGATION INCENTIVES.	19
A. The Commission Should Not Reverse Its Earlier Decision Rejecting the Use of Balance Sheet Deferral Accounts.	19

B.	The Proposed Deferral Method Fails to Consider the Perverse Litigation Incentives It Creates or the Extreme Administrative Burdens and Cost Involved in Tracking Such Expenses.	22
C.	Litigation Costs are A Normal Part of Conducting Business.	26
VI.	THE PRESUMPTION SHOULD NOT BE EXTENDED TO VIOLATIONS OF OTHER FEDERAL STATUTES.	27
VII.	CONCLUSION	29

SUMMARY*

The rules and presumptions of below-the-line treatment of adverse judgments, settlements and litigation costs proposed in the NPRM should not be adopted. The presumptions are contrary to the standards for disallowance of expenses established by the United States Supreme Court and recognized and followed by this Commission for over 52 years. The presumptions are arbitrary and capricious in that they presume imprudence and bad faith based solely on the outcome of litigation wherein prudence and bad faith are not normally elements of proof. The reality of business simply does not support the presumption that every time a business loses a lawsuit involving a statutory violation it means that the employees acted in bad faith or that the business acted in bad faith in deciding to defend itself. Further, the basic premise that if the carrier loses the litigation the ratepayer could not have benefitted from the conduct is flawed.

Instead of benefitting the ratepayer the rules and presumptions create artificial perverse incentives which will benefit opposing counsel to the detriment of both the carrier and the ratepayer. The rules create incentives to fight litigation and appeals which might otherwise be settled and settle cases which would otherwise be fought in absence of the rules.

The NPRM also proposes a balance sheet deferral method of accounting for litigation expenses which was rejected by the Commission less than seven years ago. The balance sheet deferral

*All abbreviations used herein are referenced within the text.

method is contrary to GAAP and should be rejected once again. In addition, the requirement that litigation costs be tracked and deferred for later imposition of a presumption based solely on the outcome of the litigation ignores the fact that litigation costs are a normal operating expense. Basing the presumption of reasonableness of the defense solely on the outcome of the litigation is arbitrary and capricious. The deferral of expenses proposal also fails to take into account the adverse affect the rules will have on litigation and the inherent administrative burden, time and expense involved in separating costs between statutory and nonstatutory claims in the same lawsuit.

The changes proposed by the NPRM create a windfall for opposing counsel, interject artificial incentives into the litigation equation and work to the detriment of both the carrier and the ratepayer. The Commission should reject the proposals contained in the NPRM and continue to follow the established standards for disallowing expenses which do not frustrate the carrier's litigation defense and do not create artificial incentives to the detriment of the ratepayer.

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Southwestern Bell Telephone Company (SWBT), by its attorneys, files the following Comments in response to the Federal Communication Commission's (Commission) Notice of Proposed Rulemaking¹, which seeks to reinstitute a change in the traditional accounting and ratemaking methodology regarding the treatment of certain litigation costs. The proposed change would create a presumption that certain judgments, settlements and litigation costs incurred in operating the carrier's business should not be included in the cost of service in setting rates.² The Commission attempted to institute similar presumptions in regards to the Litton antitrust litigation³ and in a litigation costs rulemaking⁴

¹In the Matter of Accounting for Judgments and Other Costs Associated with Litigation, CC Docket No. 93-240, Notice of Proposed Rulemaking (Released September 9, 1993). (NPRM)

²See, NPRM, para. 10.

³Accounting Instructions for the Judgment and Other Costs Associated with the Litton Systems Antitrust Lawsuit, 98 FCC 2d 982 (1984) recon. denied, 3 FCC Rcd 500 (1988) (collectively Litton Cost Proceeding).

⁴Notice of Proposed Rulemaking to Amend Part 31 Uniform System of Accounts for Class A and Class B Telephone Carriers to Account for Judgments and Other Costs Associated with Antitrust Lawsuits and Conforming Amendments to the Annual Report M, Report and Order, 2 FCC Rcd 3241 (1986) (1986 Litigation Cost Order); recon., 4 FCC

established in the mid-1980's. The Commission's Orders in both of the proceedings were vacated and remanded by separate panels of the United States Circuit Court of Appeals for the District of Columbia on July 23, 1991.⁵ The NPRM is in response to the remand of the Litton Cost Proceeding and the 1986 Litigation Costs Proceeding and seeks to reinstitute similar rules leading to the same presumptions.

I. INTRODUCTION

The NPRM mischaracterizes the history of the Commission's treatment of litigation costs for accounting and ratemaking purposes by claiming that the 1986 Litigation Cost Proceeding was instituted "in response to the need for a clear policy on how litigation costs should be recorded on the carriers books of account".⁶ Beginning with its inception in 1934 the FCC had a clear and consistent policy for treating litigation costs--it treated litigation judgments, settlements and costs as any other expense--they were recorded in specific operating accounts and were subject to disallowance by the Commission upon a proper showing. This policy was examined and reaffirmed in 1982 when, after

Rcd 4092 (1989) (1986 Litigation Cost Recon. Order) (collectively 1986 Litigation Costs Proceeding).

⁵Mountain States Telephone and Telegraph Co. v. Federal Communications Commission, 939 F.2d 1021 (D.C. Cir. 1991) (Litton Decision); Mountain States Telephone and Telegraph Co. v. Federal Communications Commission, 939 F.2d 1035 (D.C. Cir. 1991) (Litigation Costs Decision).

⁶NPRM, para. 2.

soliciting comments from interested parties, the Commission terminated its inquiry into the "policy to be followed in connection with treatment of litigation expenses for ratemaking purposes" finding that its traditional treatment of litigation costs was adequate⁷ and consistent with applicable rulings of the United States Supreme Court.⁸ As recognized by the United States Circuit Court of Appeals for the District of Columbia, the recent decision of the Commission to presume the illegitimacy of expenses associated with antitrust and other forms of federal litigation and cast them below the line is "undeniably a radical departure from past practice".⁹

Thus, this docket is not about what rules need to be developed to fill a vacuum or establish a clear policy. Rather this docket is to examine on remand whether the Commission should change its traditional policy, traditional at least until the mid 1980's, that litigation costs should be treated as any other expense incurred in operating the carrier's business and whether such a change is contrary to the principles established by the

⁷In the Matter of Policy to be Followed in the Allowance of Litigation Expenses of Common Carriers in Ratemaking Proceedings, CC Docket 79-19, 91 FCC 2d 140, 146-147 (1982) (1982 Litigation Cost Order).

⁸1982 Litigation Cost Order, 91 FCC 2d at 144, citing Southwestern Bell Telephone Co. v. Public Service Commission of Missouri, 262 U.S. 276, 288-89 (1922); West Ohio Gas Co. v. Public Utilities Commission of Ohio, 294 U.S. 63, 74 (1934).

⁹Litton Decision, 939 F.2d at 1035.

United States Supreme Court¹⁰ and recognized by the Commission as recently as 1982.¹¹

The proposed rules should not be adopted. There is no reason for the Commission to change its traditional policy regarding accounting and ratemaking treatment of litigation judgments, settlements and expenses. The proposed rules will detrimentally affect the litigation process by imposing artificial incentives regarding defense strategies, treatment of frivolous claims and settling cases. The main beneficiary of the proposed changes will be opposing attorneys and their clients who will realize the artificial incentives the rules create and use the rules to gain an advantage to the detriment of the carrier, the ratepayer and the shareholder.

The proposed rules also impose burdensome and costly reporting requirements and accounting methods which are contrary to Generally Accepted Accounting Principles (GAAP) and were rejected by the Commission in the 1986 Litigation Cost Order.¹² The tracking rules fail to take into account the fact that seldom, if ever, does a lawsuit involve solely anti-trust or federal statutory claims. Rather, litigation normally involves multiple claims based on differing theories of recovery, including both common law and statutory claims. The tracking rules are burdensome and costly

¹⁰See, Southwestern Bell Telephone Company, 262 U.S. at 288-89; West Ohio Gas Co., 294 U.S. at 74.

¹¹1982 Litigation Cost Order, 91 FCC 2d at 144.

¹²1986 Litigation Costs Order, 2 FCC Rcd at 3247.

because of the time and expense associated with developing and following accounting methods to separate costs between the common law claims and any anti-trust or federal statutory law claims. The burden associated with having to track such costs will be realized by opposing attorneys who may now include anti-trust or federal statutory claims which otherwise might not have been pursued merely to gain an advantage in the litigation, to the detriment of the carrier and the ratepayer.

The NPRM claims that the below-the-line presumption is tied to a need to protect ratepayers. The NPRM overlooks the fact that a vehicle already exists to protect ratepayers--something that does not create perverse incentives and a windfall for opposing counsel. The established standards for ratemaking treatment the Commission followed for over 52 years and approved of as late 1982¹³ are sufficient to protect ratepayers. The Commission should continue to follow the established standards. As the Commission determined in 1982, the "current ratemaking treatment is adequate protection against unreasonable litigation spending".¹⁴

II. THE PROPOSED RULES SHOULD NOT BE ADOPTED BECAUSE THEY CONFLICT WITH ESTABLISHED JUDICIAL AND REGULATORY STANDARDS.

In 1923, the United States Supreme Court, in determining whether a Missouri Public Utility Commission Order reducing exchange rates was confiscatory and in conflict with the 14th

¹³1982 Litigation Costs Order, 91 FCC 2d at 144.

¹⁴1982 Litigation Costs Order, 91 FCC 2d at 147.

Amendment, adopted the now well established regulatory standard applicable to presumptions for determining whether expenses should be included in a utility's cost of service.¹⁵ The Court ruled that, while a commission may regulate rates, "it is not empowered to substitute its judgment for that . . . of the corporation nor can it ignore items charged by the utility as operating expenses unless there is an abuse of discretion in that regard by the corporate officers."¹⁶ The Commission cites the same decision and doctrine in its 1982 Litigation Cost Order, acknowledging that "good faith is presumed on the part of a carrier's management" and "public utility commissions should not substitute their judgments as to the reasonableness of expenditures in the absence of a showing of inefficiency or improvidence".¹⁷

As the Appellate Court noted in rejecting the presumption of below-the-line treatment in the Litton Decision and as the Commission has recognized, regulatory agencies have been admonished by the Supreme Court to "give heed to all legitimate expenses that will be charges upon income during the term of regulation".¹⁸ The Litton Decision noted, quoting the Commission, that regulatory agencies "may disallow expenses actually incurred in the company's

¹⁵Southwestern Bell Telephone Company, 262 U.S. at 288-289.

¹⁶Id.

¹⁷1982 Litigation Cost Order, 91 FCC 2d at 144, citing Southwestern Bell Telephone Co., 262 U.S. 288-89 and West Ohio Gas Co. v. Public Utilities Commission of Ohio, 294 U.S. 63, 74 (1934).

¹⁸Litton Decision, 939 F.2d at 1029 and 1982 Litigation Order, 91 FCC 2d at 144, quoting West Ohio Gas Co. 294 U.S. at 74.

operation where the challenged expense is found to be exorbitant, unnecessary, wasteful or incurred in the abuse of discretion or in bad faith, or of a non-recurring nature."¹⁹ Thus, the general rule has been that reasonable litigation costs incurred in good faith must be included among the utility's operating costs in computing a fair return.²⁰

The presumption of illegitimacy and disallowance of certain expenses proposed in the NPRM violates the standards established by the United States Supreme Court and accepted by the Commission until 1986. In the Litton Decision the Appellate Court noted in rejecting the below-the-line presumptions that it had "not been referred to any authority either mandating or unequivocally authorizing the Commission's singular accounting prescription or presumption".²¹ On remand, the NPRM fails to provide such authority but instead chooses not to follow the Litton Decision if it conflicts with the NPRM's proposed rules.²²

SWBT does not agree with the limitations the NPRM places on the Litton Decision. The Litton Decision is based on United States Supreme Court opinions and rationale relied on by the Commission as late as 1982.²³ The Commission should continue to

¹⁹Litton Decision, 939 F.2d at 1029, quoting 1982 Litigation Cost Order.

²⁰West Ohio Gas Co., 294 U.S. at 73-75.

²¹Litton Decision, 939 F.2d at 1030.

²²NPRM, at para. 29.

²³Litton Decision, 939 F.2d at 1029-35; 1982 Litigation Cost Order, 91 FCC 2d at 144-47.

treat litigation judgments, settlements and expenses in the traditional manner, pursuant to the standards established by the Supreme Court and consistently recognized, until 1986, by this Commission--as any other expense, subject to disallowance by the Commission on a proper showing.

III. THE PRESUMPTIONS PROPOSED IN THE NPRM ARE FUNDAMENTALLY UNFAIR.

A. The NPRM Uses an Unfair, Arbitrary and Capricious Standard as a Basis for its Presumptions.

The primary problem with the below-the-line presumptions outlined in the NPRM is that they are not based on the traditional standards for disallowance of expenses but instead rely on a hindsight based test which does not consider the prudence of the employees' actions. As discussed above, the true test for inclusion in above-the-line accounts is whether the conduct giving rise to the expense was reasonable and prudent in the provision of service.²⁴ The Commission is not to replace its judgment for the judgment of the carrier's management but rather the expenses are to be allowed unless the expense is deemed to be imprudent or incurred in bad faith.²⁵ The NPRM in one broad swipe erases all the established time-tested standards and replaces them with an arbitrary standard of "did the expense benefit the ratepayer" based solely on a judge or jury determining that a statute has been violated. Instead of looking at the prudence of the employees'

²⁴See Section II, supra.

²⁵Id.

judgment at the time of the conduct, the Commission would look solely at the outcome of litigation to impose a presumption of disallowance that the Commission admits will be difficult to rebut.²⁶

As the Appellate Court in Litton notes "a persuasive element in ratemaking is reasonableness, which demands inquiry beyond the bare fact of an antitrust violation".²⁷ The test suggested in the NPRM does not consider whether the employees' actions at the time were prudent or in good faith but rather looks solely at the outcome of litigation in which prudence or good faith is seldom, if ever, a factor. The fact that a carrier is involved in a lawsuit does not mean that the managers have mismanaged the business or engaged in imprudent activities. As the Circuit Court of Appeals noted, a carrier may make the "right" decision, i.e. what the ratepayers would have decided in their own economic self interest, however it turned out to be a "wrong" decision as a matter of how the law was finally interpreted.²⁸ It is fundamentally unfair to create a presumption that the past conduct of the carrier's employees was imprudent or in bad faith solely because of an adverse verdict several years later. It is even more fundamentally unfair to presume that the carrier's decision to defend itself from allegations made regarding such conduct was

²⁶NPRM, at para. 10; See also Litton Decision, 939 F.2d at 1030; 1986 Litigation Costs Order, 2 FCC Rcd at 3257, ft. 4.

²⁷Litton Decision, 939 F.2d at 1031.

²⁸Litigation Costs Decision, 939 F.2d at 1045.

imprudent or in bad faith solely because of an adverse verdict.

In addition, as noted in the Litigation Cost Decision, by failing to consider the prudence of the employees' judgment, the presumption forces carriers to take the most conservative approach possible, which is not always in the ratepayers' best interest.²⁹ Contrary to the NPRM's assumption, antitrust and other federal statutes do not clearly define what is prohibited conduct. For example, the same set of basic facts have resulted in court rulings that are diametrically opposed in interpretation of whether there was a federal antitrust violation.³⁰ Antitrust suits frequently present a multitude of complex issues, many of which may be intertwined with esoteric economic concepts in a legal context where precedents and clear standards may be lacking.³¹ Many times the final decision as to whether conduct violates a statute must await a decision by an appellate court or even the Supreme Court as to the true meaning of the statute.³²

²⁹Litigation Costs Decision, 939 F.2d at 1046-1047; See also, 939 F.2d at 1044-1045.

³⁰Compare, Southern Pacific Communications Co. v. American Tel. and Tel. Co., 556 F.Supp. 825 (D.D.C. 1983), aff'd 740 F.2d 980 (D.C. Cir. 1984), cert. denied, 84 L.Ed. 2d 380; with MCI v. American Tel. & Tel. Co., 708 F.2d 1081 (7th Cir. 1983), cert. denied 104 S.Ct. 234, appeal after remand 748 F.2d 799 (7th Cir. 1984). In Southern Pacific, Judge Richey found no antitrust violations in a case with facts similar to what the jury found constituted a violation in the MCI case.

³¹Litton Decision, 939 F.2d at 1034.

³²See, e.g., Hospital Building Company v. Trustees of the Rex Hospital, 425 U.S. 738, 743 (1976). (The United States Supreme Court notes in Hospital Building Company that "when Congress passed the Sherman Act in 1890, it took a very narrow view of its power under the Commerce Clause. . . . Subsequent decisions by this

Equally as troublesome is the fact that some courts have imposed antitrust liability even when the conduct complained of consists of the carrier adhering to its tariffs.³³ Carriers are required by law to adhere to their state and federal tariffs which conduct undeniably benefits ratepayers and is reasonable in the provision of service. State PUCs and the FCC sometimes force the carriers to set rates or follow regulations to achieve public policy goals, including subsidizing the cost of some services with others. This creates an environment ripe for antitrust litigation, especially in a regulatory environment which is transitioning towards competition. To automatically impose a presumption of

Court have permitted the reach of the Sherman Act to expand along with expanding notions of congressional power. Cites omitted.)

³³See, Cause No. 89-CV-0240; Metro-Link Telecom, Inc., et al v. Southwestern Bell Telephone Company, et al; in the 56th Judicial District Court of Galveston County, Texas. In this case, Southwestern Bell marketing representatives sold local exchange services to an ex-Southwestern Bell employee for his new business of providing a flat-rated calling service between Houston and Galveston. The Southwestern Bell representatives mistakenly accepted Metro-Link's explanation that they did not need to buy Access Services because they were only providing an intraLATA calling service. Once Southwestern Bell personnel were aware that the use Metro-Link was making of the service was in violation of Southwestern Bell's PUC approved tariffs and that Metro-Link like all other IXCs, should have been paying Access Service rates, Southwestern Bell notified Metro-Link that conversion would be necessary. A PUC complaint was ultimately filed by Metro-Link in regard to this situation, as well as an antitrust lawsuit. A jury recently awarded antitrust damages and attorney's fees in a \$5,710,000 judgment on the basis that Southwestern Bell withheld essential facilities at reasonable rates. Such judgment was entered despite the fact that a final order has not yet been entered in the PUC docket, Metro-Link has at all times been provided the "essential services" under the rates they contend are "reasonable" because of an interim relief order at the PUC, and a hearings examiner found that Metro-Link is indeed an IXC, which finding Metro-Link did not challenge. Southwestern Bell is in the process of appealing this decision.

disallowance because of an adverse judgment in such a case is unwarranted.

Employees do not make a decision to violate federal statutes--employees make decisions to further the interests of the business, including the ratepayers. The Commission recognizes that lawsuits are common in operating a business and that companies must defend themselves against such lawsuits.³⁴ Most carriers, like any other large business, are seen as "deep pockets" and targets for litigation. The resultant litigation is neither avoidable nor imprudent--it is a necessary expense of running a business. To ignore the prudence of the employees' judgment as well as the carrier's decision to defend itself and look instead merely at the result of such litigation to impose a presumption of disallowance of the expense associated with the litigation is arbitrary and capricious.

B. The Rationale for Imposing the Presumption is Based on False Assumptions.

The NPRM's only rationale for imposing the presumption of non-inclusion of adverse antitrust judgments is an assumption that "anticompetitive behavior rarely if ever, produces any benefit for ratepayers".³⁵ This basic assumption is incorrect because carriers

³⁴Litton Cost Proceeding, 98 FCC 2d at 984. As various parties pointed out in the 1982 and 1986 Litigation Cost Proceedings and as noted in the Litton Decision, litigation and litigation costs are a normal part every day business. See, 1982 Litigation Cost Order, 91 FCC 2d at 147-148.

³⁵NPRM, at para. 9. As discussed above in Sections II and III, the "post-litigation/benefit the ratepayer" is not the accepted standard for judging decisions made by employees of the carrier and should not be followed.

normally do not undertake any actions or conduct unless it is profitable and those profits would generally also benefit the ratepayers.³⁶

Further, the implied rationale for the presumption of non-inclusion is flawed. The rationale for the presumption appears to be that carriers will wilfully break the law if they can pass the expenses to the ratepayers. This rationale presumes that a carrier will know that the conduct violates the statutes, reason that the ratepayers will pay for the violation and then go forward with the conduct. If an environment existed where the law was undeniably clear and there were no criminal penalties, no adverse publicity and 100% guarantee of 100% recoverability in a rate case the rationale might have merit. Such an environment however never has existed and does not exist now.

As discussed above there is not always a bright line between conduct that is permitted by antitrust and other federal statutes and conduct that is prohibited by such statutes.³⁷ The antitrust laws impose severe criminal penalties including imprisonment, for misconduct.³⁸ The same is true for violations of other federal statutes.³⁹ Criminal penalties may be imposed not only on the corporation but also on the employees involved.⁴⁰

³⁶See, *Litigation Cost Decision*, 939 F.2d at 1044-1045.

³⁷See Section III. A. *supra*.

³⁸See, 15 U.S.C. §§ 1,2,13 (1993).

³⁹See, 15 U.S.C. §§ 77, 78 (1993).

⁴⁰See, e.g., 15 U.S.C. § 24 (1993).

Carriers are directly impacted by the adverse publicity a lawsuit brings, especially one alleging federal law and criminal violations. Adverse publicity of such a serious charge impacts the carrier's stock price and lowers consumer confidence in the carrier and its affiliated companies. Further, there is no guarantee of recovery because under the traditional standards the expense is subject to challenge and may be disallowed. The lack of a presumption for disallowance simply does not encourage carriers to violate the law or treat it with any less respect.

IV. IMPOSING A PRESUMPTION OF DISALLOWANCE ON SETTLEMENTS MERELY BECAUSE THERE ARE ALLEGED VIOLATIONS OF ANTITRUST OR FEDERAL STATUTES IS ARBITRARY AND CAPRICIOUS, AND WILL HAVE AN ADVERSE AFFECT ON LITIGATION.

A. The Presumption of Disallowance is Arbitrary and Capricious.

The NPRM proposes a presumption of disallowance on settlements of lawsuits if the lawsuit involves allegations of violation of antitrust laws or other federal statutes.⁴¹ The NPRM treats settlements of such cases in the same manner as adverse judgments based on the rationale that "a carrier settles an antitrust case because it is likely to lose the litigation" because most defendants settle "under the real specter of the consequences of losing the case".⁴² As the Section of Antitrust Law of the American Bar Association (ABA) pointed out in its Reply Comments

⁴¹NPRM, at paras. 11, 24-25.

⁴²Litigation Cost Proceeding Notice of Proposed Rulemaking, at para. 7.

regarding this rationale "Bluntly stated, this proposition is erroneous as a matter of fact and law, and is contrary to the sound public policy favoring the settlement of disputes".⁴³

As the Commission noted, the ABA took vigorous exception to the Commission's analysis and perception of why lawsuits are settled, as did the carriers.⁴⁴ Nothing has changed since the issue was raised by the Commission in the 1986 Litigation Order Proceeding. Settlements are entered for a variety of reasons, a plaintiff may settle because its case is weak; a defendant because it will cost more to litigate. Parties may settle because of the uncertainty of protracted litigation, including: the potentially open-ended burden on the time and energy of management; the disruption of business in discovery, trial preparation and trial; the effect on employee and customer perceptions; and the need to focus resources elsewhere.⁴⁵ To impose a presumption, admittedly difficult to rebut,⁴⁶ of disallowance on settlements based solely on the presence of allegations of violations of antitrust laws or federal statutory law is arbitrary and capricious.

B. The Presumption of Disallowance of Settlements Should be Rejected Because of the Adverse Effect on Litigation.

The NPRM also fails to consider the adverse effect the

⁴³Reply Comments of the Section of Antitrust Law of the American Bar Association, p. 3, filed July 15, 1985, 1986 Litigation Cost Proceedings, CC Docket 85-64.

⁴⁴1986 Litigation Costs Proceeding Order, 2 FCC Rcd. at 3245.

⁴⁵See, ABA Reply Comments, p. 3.

⁴⁶NPRM, at para. 10; See also Litton Decision, 939 F.2d at 1030; 1986 Litigation Costs Order, 2 FCC Rcd at 3257, ft. 4.

presumption of disallowance will have on litigation. The presumption adds artificial incentives to the litigation equation which will make it more costly to litigate and will harm the ratepayer. Opposing attorneys will realize the artificial incentives and will include, whenever possible, antitrust and federal statutory claims knowing that it will impact the manner in which the carrier must treat the case. For example, opposing counsel will attempt to force settlements by threatening to add antitrust or federal law violation claims to existing litigation or by offering to drop such claims prior to settlement.

The NPRM also creates artificial incentives regarding the carrier's decision of whether and when to settle a case. The NPRM grants an exception to the below-the-line presumption if the carrier settles the suit for "nuisance value". Nuisance value has previously been determined to be "the amount corresponding to the additional litigation costs, expressed in present value terms, which the carrier reasonably estimates it would have paid if it had not settled".⁴⁷ On questionable claims the presumption creates an incentive for a carrier to settle at nuisance value early in the case before costly discovery is completed and the facts become clear. This artificial incentive to settle early exists because the further the case proceeds, the less litigation costs there are to be saved and the settlement value goes down. In addition, many times motions affecting the final result of the lawsuit, such as motions for summary judgment, are not decided until the eve of

⁴⁷1986 Litigation Cost Recon. Order, 4 FCC Rcd. at 4097.

trial. Carriers will be less likely to await the outcome of such motions because they will be less likely to settle for "nuisance value" and take the costs above-the-line when the only expense left to include in the nuisance value calculation is trial expense.

Using the cost of further litigation as the determining factor for above-the-line recovery also has an adverse incentive on how carriers will treat future inflated damage claims or questionable liability claims. For example, an opposing party may have a plausible liability claim but an outlandish damage claim. In the past, it was to the carrier's advantage to litigate the suit rather than pay more than the probable damages award in order to dissuade future inflated damage claims. For similar reasons, many times a case which could be settled for less than the cost of continued litigation is aggressively tried to dissuade others from bringing questionable suits or inflated claims.⁴⁸ Knowing that a company would rather litigate than pay outlandish damages or pay on a questionable liability claim keeps settlement claims reasonable.

⁴⁸See, Metty v. Shurfine Central Corporation and Allen Canning Co., 736 S.W. 2d 527 (Mo. Ct. App. 1987). In Metty the plaintiff allegedly found a part of a grasshopper in green beans produced by defendants. In Associate Circuit Court, plaintiff recovered a \$2,500 judgment. Defendants were automatically granted a trial de novo on request before the Circuit Court which granted a \$1,850 judgment on behalf of plaintiff. Defendants appealed based on plaintiff's alleged lack of making a submissable case. The Appellate Court affirmed the lower court and defendant's Application to Transfer to the Missouri Supreme Court was denied. Defendants most likely spent more money pursuing the litigation than paying the initial judgment; however, management obviously felt that the money invested in the litigation was worth the deterrent effect the litigation would have in other litigation if the claim of liability was questionable or the request for damages inflated.

Under the proposed settlement rule it would be more advantageous for the carrier to pay up to the cost of further litigation even if that cost is more than the carrier feels the plaintiff would recover if successful or even if the settlement will spur similar inflated or questionable liability lawsuits. Again, opposing attorneys will realize this artificial incentive and use it to their advantage.

The NPRM does not apply the nuisance value exception to post-verdict settlements.⁴⁹ Thus, the presumption also creates artificial incentives to continue fighting cases lost at the trial level which could otherwise be settled for less than the cost of appeal and expend money expunging antitrust or federal claims when liability is unlikely to be erased. An opposing party may be willing to settle a case prior to appeal because of doubts about the verdict withstanding appellate review. The settlement offer might be less than the cost of the appeal however, given the NPRM's presumption, the carrier would most likely turn down the settlement, spend the additional money to win the case on appeal and have the costs, including the additional costs associated with the appeal, booked in above-the-line accounts. The presumption likewise creates an incentive for a carrier to appeal multiple count cases even if escape from total liability does not seem probable. For example, the vast majority of litigation involve multiple claims. A verdict might be considered very strong on a breach of contract claim but weak on a finding of antitrust or

⁴⁹NPRM, at para. 14.

federal statute violation. Absent rules such as those proposed here, the carrier would not appeal because it is not cost effective, given that liability would not likely not be extinguished. Under the proposed rules, however, the carrier would be expected to appeal to get the antitrust or federal law violation overturned so that the cost of the judgment and the litigation costs, including the cost of the appeal, are included in the cost of business for ratemaking purposes.

The treatment of settlements outlined in the NPRM introduces numerous artificial and adverse incentives into the litigation equation--incentives which benefit opposing counsel to the detriment of the carrier and ratepayer. The Commission should reject the presumption of below-the-line treatment for settlements and should continue to follow its established method as outlined in Sections II and III above.

V. THE PROPOSAL THAT CARRIERS BE REQUIRED TO TRACK LITIGATION EXPENSES IN A BALANCE SHEET DEFERRAL ACCOUNT IS CONTRARY TO GAAP, OVERLY BURDENSOME AND WILL CREATE ADVERSE LITIGATION INCENTIVES.

A. The Commission Should Not Reverse Its Earlier Decision Rejecting the Use of Balance Sheet Deferral Accounts.

The NPRM proposes to require incurred litigation expenses to be completely excluded from the carrier's regulated books for however long it takes to resolve the litigation and then booked depending on the outcome of the litigation when the litigation is completed.⁵⁰ This same proposal was considered by the Commission

⁵⁰NPRM, at para. 17.

less than seven years ago in the 1986 Litigation Costs Proceeding and rejected as being administratively burdensome and inconsistent with fundamental accounting principles.⁵¹

One of the primary principles of accounting - recognition of revenues and expenses - calls for expenses to be recognized in the period they occur unless it can be determined that the benefit extends over future periods. The Financial Accounting Standards Board Statement of Concepts 6 provides the rationale and merits of current period expense recognition.⁵² Under GAAP, costs which do not benefit, or relate to, future periods in any way are simply not deferred and classified on the balance sheet. GAAP provides three pervasive expense recognition principles; associating cause and effect, systematic and rational allocation, and immediate recognition. Litigation costs, which are the subject of this NPRM, are not related directly to particular revenues. These costs are incurred to obtain benefits that are exhausted in the period in which the costs are incurred, therefore they should be recognized immediately by a charge to income. Recognition of these types of expenses is largely independent of recognition of particular revenues, but they are deducted from particular revenues by being recognized in the same period.⁵³

The Commission has consistently demonstrated its support

⁵¹1986 Litigation Costs Order, 2 FCC Rcd. at 3247.

⁵²See, FASB Statement of Concepts No. 6 (CON6), Elements of Financial Statements, at paragraphs 147 and 148 and footnote 57 for a more detailed discussion.

⁵³Id.